Behavioral Finance and Implications for Regulation: China's Stock Market

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Abstract

In regulation of financial services, supervisory authorities have relied to a great extent on theoretical models developed in academia and applied to the often less predictable world of financial markets[1]. The theory typically assumes that investors are rational, whereas countless empirical studies indicate that often the reverse is true[2]. This short exposition argues that regulators should take greater account of the many human behavioural factors affecting investment decisions, and uses the Chinese "equity mania" of 2015 as an example[3]. A classic case of an asset bubble, this ultimately destructive phenomenon was facilitated by the authorities, who loosened regulations in an ill-advised effort to boost domestic investment. Classic examples of irrational behavioral heuristics on the part of investors, who were largely made up of poorly educated individuals, were manifested in this bubble, repeated so often throughout the world and over the centuries[4]. These include errors of framing, overconfidence, hindsight and confirmation, as well as herding errors[5]. The value destruction witnessed in the Chinese example emphasises the need to try and incorporate behavioural errors into forward thinking regulation; for example, as retail dominated, debt fuelled investment rises, this would be the time to place more controls on margin lending, rather than reducing them[6]. Ongoing analysis of such events, and implementation of lessons learned, thus have important implications for public policy in financial services, the overriding aim of which should be financial stability.

1. For example, the BIS (Bank for International Settlements) Basel framework for market risk relies heavily on models which tend to assume normal distributions of returns (bis.org/bcbs/publ/d352.pdf). For discussion of efficient markets hypothesis relative to human behaviour, see for example, Shiller, R. (2003) *From efficient markets theory to behavioural finance*, Cowles Foundation for Research Economics at Yale University, paper 1055
2. See, for instance, Fisher, K. & Statman, M. (2006) *Market timing in regressions and reality*, Journal of Financial Research
3. Hsu, J. (2015) *The China syndrome: lessons from the A-shares bubble*, Research Affiliates
4. See for example Kindleberger, C. (1978) *Manias, panics and crashes: a history of financial crisis:* Basic Books
5. Statman, M. (2011) *What investors really want*: McGraw Hill
6. An example of such regulation is given by the US Securities & Exchange Commission, available on SEC.gov/investor/alerts/ib_marginaccounts.pdf